LNG facilities and interconnectors : EU legislation and regulatory regime

DTI/Ofgem initial views

June 2003

Summary

New EU gas and electricity Directives and electricity Regulation include provisions that apply directly to the regulation of gas and electricity interconnectors and LNG and storage infrastructures. The Directives must be implemented by the UK government by 1 July 2004, and at this time the Electricity Regulation, which has direct effect, shall also apply. The EU legislation will require a system of regulated third party access to interconnectors and LNG facilities, and also allow national regulatory authorities to exempt such infrastructures from these requirements where certain criteria are met. Any decision to exempt must be notified to the European Commission, who retain a veto.

The question of the appropriate regulatory regime for these infrastructures arises simultaneously with the advent of a number of proposed new gas and electricity interconnector and LNG projects. A number of these developers are seeking early guidance on the implications of the EU legislation, how it will be applied in the UK, and how it might affect them individually in terms of the exemption.

The DTI is the government department responsible for implementing where necessary this EU legislation. This document is therefore a joint DTI – Ofgem paper. It sets out our initial view regarding the regulatory regime for interconnectors and LNG facilities. In order to increase regulatory certainty for infrastructure project developers, Ofgem is therefore prepared to consider applications from infrastructure project developers for early guidance on possible exemptions following the publication of, and in the light of initial views set out in, this document.

The regulatory regime will need to reflect the default obligations of the EU legislation, which are based on regulated third party access to these infrastructures. Our initial view in this paper is that default obligations will comprise among other things the publication of tariffs on a non-discriminatory basis, with the tariffs or tariff methodologies approved ex ante by the regulatory authority. There will also be certain rules relating to the offer to the market of capacity rights to access these infrastructures.

The EU legislation allows the relevant authority, likely to be Ofgem, to grant an exemption to a major new infrastructure project from these requirements. The project must satisfy certain criteria to be eligible for this exemption. This paper sets out our initial view as to how Ofgem will apply these criteria in considering any application for exemption. It also sets out our initial view as to how the exempt regime itself will differ from the default regime.

It is important to note that the new EU legislation has not yet been implemented into UK law and that any amendments to UK law which are made in order to do so may be different to those currently envisaged. The initial views set out in this paper may change if the requisite amendments to UK law prove to be different to those envisaged, or as a result of any responses to the initial views set out in this paper. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into UK law and initial views of how the new regulatory regime may operate.

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1. Rationale

1.1. The new EU gas and electricity Directives[1] and electricity Regulation[2] include provisions that apply directly to the regulation of gas and electricity interconnectors and LNG and storage infrastructures. The Directives must be implemented by the UK government by 1 July 2004, and at this time the electricity Regulation, which has direct effect, shall also apply.

1.2. In brief, the EU legislation will require a system of regulated third party access to interconnectors and LNG facilities, and also allow for such infrastructures to be exempt from these requirements where certain criteria are met.

1.3. These issues arise simultaneously with the advent of a number of proposed new gas and electricity interconnector and LNG projects. A number of developers of these projects have approached or are approaching DTI and Ofgem to seek views both on how the EU legislation will be implemented into UK law and the process and likelihood of the grant of exemptions.

1.4. The DTI is the government department responsible for implementing the new EU legislation. It intends to issue a consultation paper in autumn 2003 on the necessary implementation measures. Since the legislation concerns the gas and electricity markets, the DTI and Ofgem intend to work closely together on this implementation process.

1.5. However, given the implications for interconnectors and LNG facilities and the advent of a number of new projects for these, DTI and Ofgem have already begun to consider the regulatory regime that might be applicable in this area, and how this might be transposed into law, in a way that meets both the requirements of the EU legislation and within the context of wider regulatory aims.

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[1] Directive of the European Parliament and of the Council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC; and Directive of the European Parliament and of the Council concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC

[2] Regulation of the European Parliament and of the Council on conditions for access to the network for cross-border exchanges in electricity.

1.6. This document is therefore a joint DTI – Ofgem paper. It sets out our initial view regarding the regulatory regime for interconnectors and LNG facilities. This regime will comprise the obligations that might be imposed and the extent of and process for granting an exemption.

1.7. It is important to note that the new EU legislation has not yet been implemented into UK law and that any amendments to UK law which are made in order to do so may be different to those currently envisaged. The initial views set out in this paper may change if the requisite amendments to UK law prove to be different to those envisaged, or as a result of any responses to the initial views set out in this paper. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into UK law and initial views of how the new regulatory regime may operate.

2. Timetable

2.1. The EU legislation must be implemented into UK law by 1 July 2004, and at that point the electricity Regulation will take direct effect.

2.2. This paper invites views by Friday 25 July 2003. The DTI and Ofgem intend to publish a final document in September 2003, updated in light of any views received in relation to this document.

2.3. The DTI intends to issue a separate consultation paper on the measures needed to implement the new EU legislation. It is anticipated that this paper will be published sometime in the autumn of 2003, after the publication of the update of this paper in September. On this basis, it is intended that the views presented in the September 2003 document in relation to LNG and interconnectors will feed into the DTI's paper.

Views invited

2.4. DTI and Ofgem invite views on any of the aspects raised in this paper, and in particular where views have been specifically requested. Responses to this consultation will normally be made available in the Ofgem library and on the Ofgem website unless respondents request that they should remain confidential. Respondents should mark any part of their response (or the whole response) which is to remain confidential. If this is the case, where possible, any confidential material should be confined to appendices.

2.5. Responses marked 'LNG facilities and interconnectors : EU legislation and regulatory regime' should be sent by Monday 28 July 2003 to :

David Halldearn
Director – Scotland and Europe
Office of Gas and Electricity Markets (Ofgem)
9 Millbank
London
SW1P 3GE
Fax : 020 7901 7479

2.6. Any email responses should be sent to sian.bailey@ofgem.gov.uk marked 'LNG facilities and interconnectors : EU legislation and regulatory regime',

2.7. Copies of all responses will be forwarded to the DTI.

2.8. If you wish to discuss any matters in this document, please contact Kevin James telephone 020 7901 7181, email kevin.james@ofgem.gov.uk or Shaun Kent telephone 020 7901 7199, email shaun.kent@ofgem.gov.uk.

2.9. In addition, if you wish to discuss any matters in this document with the DTI, please contact Susan Harrison (telephone 020 7215 2778, email sue.harrison@dti.gsi.gov.uk).

3. Background

3.1. The new EU gas and electricity Directives and electricity Regulation include provisions that apply directly to the regulation of gas and electricity interconnectors and LNG and storage infrastructures. The Directives must be implemented by 1 July 2004, and at this time the Electricity Regulation, which has direct effect, shall also apply.

3.2. Questions of what this legislation might mean for the regulatory regime for gas and electricity interconnectors and LNG facilities arise simultaneously with the advent of a number of proposed new gas and electricity interconnector and LNG projects. For example, there are currently four new electricity interconnectors at various stages of planning. Two are being planned by NGT in conjunction with the grid operator concerned: from GB to Norway (with Statnett), and the Netherlands (with Tennet). Two other projects, with the Republic of Ireland and another link between GB and the Netherlands are also under consideration. We are aware of one new gas interconnector between GB and the Netherlands which is being planned by Gasunie, the Dutch gas transmission company.

3.3. There are a number of LNG terminals under consideration. The details of three of these projects are already in the public domain. There is an NGT project at the Isle of Grain[3] and two other developers, ExxonMobil / Qatar Petroleum and Petroplus, are considering projects at separate sites located in Milford Haven, Wales.

3.4. In addition to these LNG import terminals, the DTI and Ofgem are aware of other market parties developing techniques, for example El Paso Natural Gas' "Energy Bridge" system, for delivering natural gas from LNG ships (with necessary regasification facilities onboard) directly into a pipeline. At present we are not aware of any plans for this approach to be introduced into the GB and this consultation document does not explicitly consider how LNG delivered in this manner would fit in the proposed regulatory regime.

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[3] The related topic of the transfer of Transco's LNG storage to a separate business was discussed in Ofgem's May 2003 consultation paper *National Grid Transco's proposal to transfer its Liquefied Natural Gas facility at Isle of Grain to a separate NGT group company*.

3.5. Against the background of these projects, the UK government will need to consider whether it is necessary, and if so how, to amend UK legislation and practice in order to comply with the new EU legislation.

3.6. Ofgem has already begun to consider the issues in the context of LNG facilities. In December 2002, Ofgem published the document *Transco's proposal to transfer its LNG facilities : update*. This set out, among other things, the implications of the new gas Directive for LNG facilities, based on the text of the draft gas Directive at that point in time. The text has not materially altered in respect of LNG facilities, and the questions and issues that that paper posed remain pertinent. The DTI and Ofgem also held a joint workshop on 28 February 2003 that included consideration of these issues. Our initial views on the regulatory treatment of LNG facilities set out in this paper should therefore be taken as a development from the December 2002 document, the February 2003 workshop, and views expressed by interested parties as a result of those two fora.

3.7. This paper sets out Ofgem/DTI's initial view of the appropriate regulatory and legislative arrangements that might be put in place for interconnectors and LNG facilities and interconnectors. This view is informed by the requirements of the EU legislation and the DTI and Ofgem's view of the appropriate regulatory arrangements for these types of projects.

3.8. Clearly in setting out an initial view on the implementation of the new EU legislation which have yet to be transposed into UK law, and bearing in mind the continued application of competition and other relevant law, it is necessary to emphasise that the caveats that should be attached to this initial view. That is, any amendments to UK law which are made in order to implement the EU legislation may be different to those currently envisaged and the initial views set out in this paper may change if the requisite amendments to UK law prove to be different to those envisaged, or as a result of any responses to the initial views set out in this paper. Interested parties therefore should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into UK law and initial views as to how the regulatory regime may operate.

4. Present legislative and regulatory arrangements

4.1. There are at present already a number of gas and electricity interconnectors to / from GB, and LNG storage facilities, but no LNG import facilities. Present legislative and regulatory arrangements mean that gas interconnector activities may be licensed under certain circumstances. There is no requirement for electricity interconnectors from GB to be licensed, and hence little scope for the direct regulation of these infrastructures. The Gas Act 1986 sets out obligations for LNG facilities. All these types of facilities will be subject to the general provisions of EU and UK competition law.

Gas interconnectors

4.2. There are presently three gas interconnectors connecting the UK to other Member States. One is from Zeebrugge in Belgium to Bacton in Norfolk, which is owned and operated by Interconnector UK Limited (IUK). The other two connect Moffat in Scotland with both the Republic of Ireland and Twynholm in Northern Ireland[4], and they are owned and operated by Bord Gas Eireann (BGE).

4.3. The Gas Act 1986 sets out the basic framework for the regulatory regime for the gas industry in Great Britain. Section 5(1) specifies that it is an offence to convey gas through pipes to any premises, or to a pipeline system operated by a gas transporter unless authorised to do so by a licence. A gas transporter is defined in section 7 (1) as the holder of a licence except where the holder is acting otherwise than for purposes connected with the carrying on of activities authorised by the licence; the conveyance of gas through pipes which are situated in an authorised area of his; or are situated in an area of a previous holder of the licence, and were so situated at a time when it was such an area; or the conveyance through pipes of gas which is in the course of being conveyed to or from a country or territory outside Great Britain. Section 6 empowers the Secretary of State to grant an exemption to this licensing requirement, which

[4] During construction of the second of these interconnectors an 11km spur pipeline was developed, linking the Isle of Man to natural gas for the first time.

may include conditions. Therefore gas interconnectors carrying gas to GB may be operated only under a licence or exemption. The UK-Belgium interconnector was granted an exemption. The interconnectors between GB and Northern Ireland and the Republic of Ireland have been deemed not to require a licence under present legislative arrangements.

4.4. Offshore gas pipeline infrastructures, including gas interconnectors, are also subject to the provisions of the Pipelines Act 1962 and the Petroleum Act 1998. These require pipeline owners to ensure non-discrimination, publication of terms when they are changed and at least annually, and negotiated access in good faith. There is a route of appeal to the Secretary of State where parties fail to agree a negotiated access. The Secretary of State may also exempt an interconnector owner from the Act's requirements where she is satisfied that existing market arrangements provide transparent terms, non-discrimination and third party access and promote competition.

4.5. The Secretary of State is therefore the regulatory authority for gas interconnectors at present.

4.6. Each interconnector has an international treaty associated with it. These set out and clarify relevant legal, technical and safety issues. The treaties also recognise the desirability of third party access to pipelines, although they do not set out direct provisions or rules for such access. The second Irish interconnector treaty contains an Article which allows "the Governments and/or their competent authorities to provide for the economic regulation of services provided by means of the pipeline". The provisions of these Treaties therefore operate in addition to the detailed UK regulatory regime.

Electricity interconnectors

4.7. There are presently two electricity interconnectors to/from GB. There is a 2000 MW undersea direct current (DC) connection to France, the IFA ("Interconnexion France Angleterre"). The other is a 500 MW undersea DC interconnector between Scotland and Northern Ireland, the Moyle interconnector.

4.8. The IFA is jointly owned by NGT and RTE, the French transmission company. It consists of four cables, two of which are owned by NGT and two by RTE, and two converter stations, the one in GB owned by NGT and the one in France by RTE.

4.9. The Moyle interconnector is owned by Moyle Interconnector Limited, a company limited by guarantee and with no shareholders, and financed by 30 year debt bonds. The System Operator Northern Ireland (SONI), a subsidiary of Northern Ireland Electricity, controls electricity flows over the Moyle Interconnector on behalf of MIL.

4.10. The Electricity Act 1989 sets out the basic framework for the regulatory regime for the electricity industry in Great Britain. Section 4 of the Act specifies that a

> " person who ... (b) transmits electricity for that purpose or; (bb) distributes electricity for that purpose" (of giving a supply to any premises or enabling a supply to so given)

shall be guilty of an offence unless he is authorised to do so by a licence.

The Act says that "transmit", in relation to electricity, means

> " transmit by means of a transmission system, that is to say, a system which consists (wholly or mainly) of high voltage lines and electrical plant and is used for conveying electricity from a generating station to a substation, from one generating station to another or from one substation to another".

The meaning of "Distribute" is given in an analogous manner.

Under section 5 the Secretary of State may grant an exemption from licensing requirements.

4.11. Hence both electricity transmission and distribution activities require a licence or exemption from licence. Electricity interconnector activities are not, however, covered by this prohibition, and so are not required to be licensed.

4.12. Regulation of the IFA therefore is presently obtained partly through Special Licence Conditions contained in NGT's electricity transmission licence. Among other things, these Special Conditions require that NGT earn no more than a

"reasonable" rate of return on the IFA, and that it ensures open and non-discriminatory access to the IFA.

4.13. Electricity regulation is a fully devolved responsibility in the case of Northern Ireland, and the regulatory situation for electricity interconnection to or from Northern Ireland differs slightly to that for Great Britain. In Northern Ireland, the definition of "transmission" includes the activity of operating an interconnector. Hence interconnector activities that involve an interconnector physically connected to Northern Ireland require a transmission licence, and so Moyle Interconnector Ltd holds a transmission licence issued by Ofreg, the Northern Ireland regulator.

4.14. There are therefore at present few legislative or regulatory arrangements in GB relating directly to the oversight of the use of electricity interconnectors. Hence at present in GB where, for example, the operator of an interconnector is not simultaneously an electricity Transmission Licence holder, that interconnector will not be subject to any explicit legislative or regulatory provisions.

LNG facilities

4.15. Natural gas can be cooled and treated in order to form a liquid, and so natural gas can be stored and transported as Liquefied Natural Gas (LNG). Hence gas can be transported in bulk by ship, and this enables imports from relatively distant natural gas sources without the need for pipeline transport. Such transport by ship would typically require an LNG import facility to handle offloads and regasification of LNG from ships.

4.16. Gas can also be stored relatively easily in LNG form, thereby enabling both gas transporters and suppliers greater flexibility to accommodate fluctuating demands for gas.

4.17. Although there are a number of LNG storage facilities currently owned and operated by Transco within GB, there are at present no LNG import facilities operating in GB.

4.18. The Gas Act 1986 contains requirements relating to LNG facilities. The Act defines an LNG facility in a way that includes storage of gas in LNG form.

4.19. The Act (section 19D) requires that any owner of a relevant LNG facility publishes terms, which must not be discriminatory, on a regular basis. The owner is also required to negotiate in good faith with parties wishing to secure terms for access to the facilities. Section 19E of the Act requires any owner to maintain accounting information relating to terms for access to the facility.

4.20. An owner of a relevant LNG facility may apply to the Authority for an exemption from the explicit regime given in section 19D of the Act and described in paragraph 4.19. The Authority is empowered to grant this exemption where the requirements of sections 19D(1), (3) and (7) are already met with respect to the facility or facilities concerned by existing market arrangements which promote competition..

4.21. The present regime therefore gives a negotiated third party access (NTPA) to LNG facilities, on non-discriminatory terms.

European and domestic competition law

4.22. Regulatory oversight of gas and electricity interconnectors and LNG facilities is also provided by general EU and UK competition law.

4.23. Articles 81 and 82 of the Treaty of Rome contain key prohibitions relating to competition in the EU. They apply to trade at a community level.

4.24. Article 81 prohibits agreements between undertakings, insofar as they affect trade between Member States, which may have as their object or effect the prevention, restriction or distortion of competition. It contains a non-exhaustive list of classes of agreement which are expressly prohibited in the absence on an exemption. An exemption for any such agreement is possible under Article 81(3) if the benefits in terms of Community objectives outweigh any deleterious effects to competition. One such objective, which is clearly applicable to interconnectors, is to improve the distribution of goods.

4.25. At present, these exemptions are given on a case by case basis, and only after the agreement has been notified to the European Commission and after the Commission has considered that the agreement meets the criteria given in Article 81(3). Revised legislation is due to come into force and apply in Member States from 1 May 2004 which will introduce a system of automatic exemptions.

That is, if an agreement meets the criteria under 81(3), it will automatically benefit from the exemption without prior application to the Commission. To assist an undertaking in deciding whether any agreement it may have falls under the benefit of 81(3), the Commission is producing revised guidelines on horizontal and vertical agreements.

4.26. Article 82 of the Treaty of Rome prohibits the abuse of a dominant position. There is no provision for exemption under this prohibition.

4.27. Other likely changes to EU competition law and the application of Articles 81 and 82 include the extension of EU competition law powers to national competition authorities. Since Ofgem holds national competition authority type powers in respect of the energy industry, Ofgem is likely therefore to receive some EU competition law powers in respect of energy.

4.28. Articles 81 and 82 are mirrored for application in the UK (i.e. at the Member State level) by the Competition Act 1998. The analogous prohibitions are the Chapter I and Chapter II prohibitions. Chapter I prohibits agreements which have as their object or effect the prevention, restriction or distortion of competition, and has some scope for exceptions and exemptions. Chapter II prohibits abuse of a dominant position. Under this Act, the Authority holds concurrent powers with the Director General of Fair Trading (the "DGFT") to consider agreements and conduct.

4.29. The Competition Act 1998 will apply if the *effect* of a prohibited practice is felt within the UK. Given the focus on effect, it may be possible therefore to capture under the Act activities related to interconnectors connected to the UK.

Merger regulations

4.30. The European Merger Regulation may apply to project arrangements, for example if the contractual entity created by the infrastructure project has a community dimension. In such cases, the Commission of the EU will have exclusive jurisdiction.

4.31. UK merger control laws under the Enterprise Act 2000 may apply to project arrangements where the UK turnover and market share thresholds specified in

the Act are exceeded. Depending on the nature and development of the project arrangements, merger control laws in other jurisdictions may also be applicable.

5. New EU legislation

5.1. New gas and electricity Directives, and an electricity Regulation, have recently been adopted. They will introduce requirements relating to regulated third party access for gas and electricity interconnectors, and LNG facilities. These Directives replace the existing 1996 Electricity Directive (96/92/EC) and 1998 Gas Directive (98/30/EC).

Background

5.2. Since the 1996 electricity Directive and 1998 gas Directive came into effect there has been a concerted attempt by the Commission to accelerate the process of liberalisation beyond that required by these Directives. While the Directives partially liberalised each Member State's electricity and gas markets, it is clear that further mechanisms were necessary to achieve single gas and electricity markets.

5.3. Reflecting these concerns and as a reaction to some of the limitations of attempts to improve upon the existing Directives through more informal arrangements, the further liberalisation of European gas and electricity markets was given considerable political impetus at the Lisbon European Council meeting in Spring 2000. And as a consequence, the European Commission adopted and proposed on 13 March 2001 a legislative package aimed at "completing the internal market".

5.4. The legislative package comprises a European Regulation on conditions for access to the network for cross-border exchanges in electricity ("the Regulation") and European Directives amending Directives 96/92/EC ("the electricity Directive") and 98/30/EC ("the gas Directive").

Gas and electricity infrastructure

5.5. The new EU gas and electricity Directives and electricity Regulation include provisions that apply directly to the regulation of gas and electricity interconnectors and LNG and storage infrastructures. The Directives must be implemented by 1 July 2004, and at this time the Electricity Regulation, which has direct effect, shall also apply.

Requirements for regulated third party access

5.6. The new gas and electricity Directives and electricity Regulation require Member States to ensure the implementation of a system of third party access to gas and electricity transmission and distribution systems, interconnectors, and LNG facilities based on published tariffs, applied objectively and without discrimination. These tariffs, or at least the methodologies underlying their calculation, are to be subject to ex-ante approval by the relevant regulatory authorities. A regime with these features is often known as Regulated Third Party Access (RTPA).

5.7. A statement by the EU Commission for entry in the Minutes from the 2465th meeting of the Council clarified that: *"Where there is a non-discriminatory and transparent auction procedure approved by the Regulator in conformity with this Directive the Commission confirms that this represents regulated third party access within the meaning of the Directive."*

5.8. The electricity Regulation also requires revenues resulting from the allocation of electricity interconnectors to be used for one or more of three given purposes. These are :

- guaranteeing the actual availability of the allocated capacity;
- network investments to maintain or increase the interconnection capacity; or
- as an income to be taken into account by regulatory authorities when approving the methodology for calculating network tariffs or in assessing whether tariffs should be modified.

Regulation of storage facilities

5.9. The new gas Directive requires Member States to enable third party access to gas storage facilities. Such access may be either on a negotiated or regulated basis, or both. The DTI and Ofgem's initial view is that the UK regime for storage facilities is already compliant with the new gas Directive, and therefore storage issues are not considered further here.

Possibility to exempt certain infrastructure from regulated third party access requirements

5.10. The new gas Directive and electricity Regulation allow regulatory authorities to exempt new interconnectors and LNG facilities from RTPA provisions and direct regulatory control of tariffs and tariff methodologies. The electricity Regulation exemption also removes the requirement for interconnector allocation revenue to be used for the prescribed purposes set out in paragraph 5.8. "New" infrastructures are defined as those not completed by the time the legislation enters into force.

5.11. The possibility to grant exemptions from the "default" regulatory requirements would therefore not apply to existing infrastructure.

5.12. The gas Directive and electricity Regulation also allows exemptions for significant increases in capacity of existing infrastructures and, in the case of gas infrastructure, for modifications to such infrastructures which enable the development of new sources of gas supply.

5.13. The Directive and Regulation do not appear to preclude an exemption applying to the total capacity of the new infrastructure and for an unlimited duration.

5.14. For those facilities that qualify to apply for an exemption, such exemptions can only to be given where certain conditions are fulfilled. These are listed in the gas Directive and electricity Regulation and can be summarized as follows :

- the investment must enhance competition in gas or electricity supply and enhance security of supply;
- the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted;
- the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built;
- charges are levied on users of that infrastructure;

- the exemption is not to the detriment of competition or the effective functioning of the internal gas or electricity market, or the efficient functioning of the regulated system to which the infrastructure is connected or linked.

5.15. In addition to these, the electricity Regulation also specifies the condition that 'since the partial market opening referred to in Article 19 of Directive 96/92/EC, no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnector'.

5.16. The legislation allows regulatory authorities to decide on rules and mechanisms for interconnector capacity allocation even where the interconnector is exempt. Indeed, the Directives specifically require regulatory authorities to maintain a general duty to ensure non-discrimination, effective competition and the efficient functioning of the market, which can be fulfilled using a range of instruments, including setting rules on the management and allocation of interconnection capacity.

5.17. Any decision to exempt an interconnector must be reached after consultation with the interconnected Member State or the relevant regulatory authority of that Member State. A decision to exempt must also be notified to the Commission. The Commission may request that the exemption be withdrawn or modified. There is a route of appeal to a Committee comprising representatives from Member States.

Continued application of EU and domestic competition and merger law

5.18. It is important to note that competition law exists and will exist independently of any consideration of competition issues or exemptions related to the default RTPA or exempt regime to apply to LNG and interconnector facilities. Any exemption from the requirement to provide RTPA for example cannot and should not be construed either as an exemption or exception under, or demonstration of compliance with, EU or UK competition law. EU and UK competition law will continue to apply, and relevant authorities will retain their powers to act, whether or not the relevant authorities grant exemptions from the

RTPA regime. Equally, any exemption or exception that is granted under EU or UK competition law cannot and should not be construed as implying that an exemption from the RTPA regime has been or should be granted.

5.19. Merger control legislation may apply to project arrangements for interconnectors and LNG facilities. Infrastructure developers will need to consider specifically the application of these rules and any requirements to notify the project arrangements for clearance by the competent merger control authorities of the EU, United Kingdom or other relevant legal jurisdiction. Any clearance that is granted under EU or UK merger control law cannot and should not be construed as implying that an exemption from the RTPA regime has been or should be granted.

6. Legislative mechanism for granting an exemption

6.1. The third party access and exemption provisions of the new EU legislation will need to be provided for in UK law. It will be helpful to map out a process for determining the circumstances in which exemptions are likely to be granted, taking into account the criteria set out in the EU legislation. This chapter describes our initial views on how this issue might be approached.

6.2. To fit appropriately within the existing legal structure within GB, and to enable the Directives and Regulation to have the appropriate effect, requires changes to existing GB legislation. Both for interconnectors and LNG facilities, it is expected that Ofgem will be the relevant authority in the GB in relation to the granting of exemptions under the Directive.

6.3. Both the Directives and Regulation, and existing GB practice in relation to the exemptions of storage infrastructure under the Gas Act 1986, require that particular infrastructure is only granted an exemption on a case-by-case basis. There is no opportunity for 'class exemptions' to apply to particular forms of infrastructure.

6.4. The DTI is minded, as soon as Parliamentary time allows, to amend the Electricity and Gas Acts to create a licensing regime for interconnectors, (i.e. prohibiting interconnector activities without a licence or exemption). Licence holders would be subject to specific licence conditions, including the default regulatory provisions outlined in chapter 7. The licensing regime would allow Ofgem to exempt licence holders from some of these default conditions (e.g. regulation of tariffs or revenues) by "turning off" certain of the default conditions. This can be seen as creating an exemption route under the terms of the EU legislation. Other licence conditions relating to interconnectors could not be turned off (e.g. anti-hoarding requirements) and would apply in both the default and exempt cases.

6.5. The extension of a licensing regime to interconnectors would allow the introduction of regulatory supervision to this activity in a manner consistent with regulation of the other main elements of the supply chain. A licensing regime

would also be sufficiently flexible to accommodate differences in market arrangements at the non-GB end of the interconnector, and any future changes or obligations imposed by EU law.

6.6. It is important that the licensing regime creates regulatory certainty for investors. The DTI and Ofgem would therefore aim to ensure that the particular interconnector activities and obligations on them are clearly defined. This would include ensuring that the route for Ofgem subsequently to modify existing or to introduce new licence conditions would be similar to its licence condition setting powers in other areas. For example, it would require either the consent of licence holders (either individually or collectively) or referral to appropriate review bodies (namely the Competition Commission).

6.7. Regarding LNG facilities (and storage), the Gas Act would already appear to apply to these forms of infrastructure, including certain powers for Ofgem to exempt operators from particular regulatory requirements. Unlike the licensing route for interconnectors, the DTI is currently minded to implement the necessary changes required by the Directive and other GB policy objectives within this legal framework. The implementation of any exemption would need to be consistent with such a legislative route, and would probably take the form of powers for the Authority to give an exemption provided that the criteria set out in the legislation are met.

Consultation with Regulators of the Commission

6.8. The Directives call for regulatory oversight of interconnection capacity to be undertaken in conjunction with the relevant authority at the other end of the interconnector, and clearly it will be helpful for the regulatory regime for interconnectors at both ends of the interconnection to be as consistent as possible. Ideally for each interconnector, regulatory authorities would agree a common set of principles, although it may be possible to agree hybrid approaches. For example, a portion of interconnector revenue might be used to offset, or be offset by, mainland transmission tariffs and hence be regulated by one regulatory authority, whereas the other portion may be unregulated by the other regulatory authority.

6.9. These considerations also apply to any decision by one regulatory authority to grant an exemption from the default regime. Hence in setting in place any default or exempt regime, Ofgem would expect to consult with the appropriate regulatory authority at the non-GB end of an interconnector.

6.10. Bearing in mind the need to notify any decision on an exemption to the Commission, and the Commission's power of veto, Ofgem would expect to consult the Commission during any process leading to a decision to grant an exemption.

Improving levels of certainty for new projects: Early guidance

6.11. As stated in chapter 3, there are a number of major investment projects that are due to finalise their decisions as to whether to proceed with their particular project. In advance of receiving full powers to regulate interconnectors and LNG, Ofgem is not legally in a position formally to exempt certain infrastructure (as contemplated by amended Directives and Regulation).

6.12. There are clearly however implications both for investors and the potential users of a particular infrastructure project regarding the regulatory regime. Although some uncertainty cannot be avoided given that legislation is not yet in force, both the DTI and Ofgem wish to improve the levels of certainty, without pre-empting the results of any consultation exercises or the will of Parliament. Such improvement can include setting out the possible regulatory regime and the generic circumstances under which infrastructure might be exempted from certain regulatory requirements, which is the main purpose of this document.

6.13. A number of infrastructure developers, in meetings with the DTI and Ofgem, have specifically requested early guidance as to whether or not their particular project might be expected to receive an exemption. Clearly this goes someway further than the generic description of the circumstances that would lead to an exemption decision as described within this document. Nevertheless, Ofgem are in principle minded to consider issuing such guidance to specific projects as to whether it is likely that the arrangements surrounding the project in question are sufficient to meet the criteria set out in chapter 8, and therefore whether the grant of exemption is likely.

6.14. The DTI and Ofgem would expect that this process would be initiated by a draft exemption request being sent to Ofgem by the infrastructure developer. Upon receiving a draft exemption request, Ofgem would seek to consult on a case-by-case basis, prior to a final decision to issue early guidance for a particular project. Applications will then be considered in the light of the initial views in this document; any views expressed by interested parties in response to this document; and any views expressed by interested parties in response to the consultation on the particular project. Guidance will not be issued with respect to a particular project prior to the publication of a final version of this paper. It is intended that the final version of this paper will be published in September 2003.

6.15. While we shall aim to ensure, as far as possible, that any potential guidance that is issued gives comfort as to the likely regulatory treatment of particular infrastructure, any such guidance issued would also be constrained to a significant extent by necessary legal caveats.

7. Proposed ''default'' regulatory regime as applied in GB

7.1. The new Gas and Electricity Directives and Electricity Regulation, require a default regime of RTPA based on published tariffs for which at least the methodology is approved ex-ante by the regulator. This could include market-based arrangements (auctions) approved ex-ante by the regulatory authority. In addition, for electricity interconnectors, the default regulatory regime requires regulation of the use of revenues arising from access to interconnectors.

7.2. Given the above requirements of the Directives and Regulation, the DTI and Ofgem propose to establish the following default regulatory regime for the different forms of infrastructure:

Default regulation of tariffs and revenues

- **TPA to interconnectors and LNG import terminals:** The default RTPA regime applied would at the very least require the following:

  - Prohibition of discrimination;
  - Publication of tariffs or tariff methodology; and
  - Ex ante approval of tariffs or tariff methodologies, which may include alternative market arrangements (auctions) which are equivalent in their effect

- **Use of electricity interconnector revenue**: Electricity interconnector operators would be required to put revenues to certain uses as specified in the electricity Regulation

Management and allocation of capacity in interconnectors and LNG terminals:

7.3. The Directives also require that regulatory authorities ensure non-discrimination, effective competition and the efficient functioning of the market, monitoring in

particular, the rules on the management and allocation of interconnector capacity. To meet this requirement the DTI and Ofgem propose to require for interconnectors and LNG facilities:

- **An initial offer of capacity to the market** in a transparent manner (for example through an effective open-season process). However, where markets are sufficiently competitive and depending on the project in question, there would be some flexibility for this condition to be loosened;

- Rules and procedures that promote, or at least do not prevent, **secondary trading of capacity rights**: this would be a general requirement to ensure there is no unjustified impediments to the transfer or sub-letting of capacity rights of specified quantity, duration or time period to third parties; and

- **"Use-it-or-lose-it"** (UIOLI) mechanisms or equivalent market arrangements that ensure capacity is not hoarded, that netting of flows in opposing directions on interconnectors can be applied effectively where possible and mechanisms to ensure that unused capacity can be obtained in a transparent market-based manner by third parties so as to maximize the use of the interconnector concerned.

7.4. In respect of interconnectors, such UIOLI mechanisms may be facilitated by an obligation to enter into an agreement with Purchasers of capacity that specify:

- A Purchaser shall not use his capacity rights in a manner that has the object or effect of restricting, distorting, or preventing competition in the use of the interconnector;

- A Purchaser will provide relevant information to an Agent (nominator), including information on held capacity rights that the Purchaser does not intend to use; and

- A Purchaser will authorise an Agent (aggregator) to dispose of the Purchaser's capacity rights that are not to be used

7.5. However, an effective UIOLI mechanism is potentially more difficult to design for LNG terminals than for access to interconnectors. For example, it has been

put to Ofgem that there may be less flexibility in terms of being able to dispatch LNG cargoes to utilise capacity that becomes available at short notice, although it is not clear necessarily how much less flexible this dispatch might be, particularly where market conditions favour it. Therefore, we will need to consider a pragmatic approach when introducing an effective UIOLI regime in this context. A number of solutions could apply, for example

- Interruptible capacity mechanisms;
- Requirements for non-nominated capacity rights to be offered to the market a certain number of periods before the trading day; and
- Bulletin boards to advertise capacity

7.6. As well as the detail of any UIOLI arrangements, we would want to consider the impact of the arrangements on primary capacity holders. It has been put to us that UIOLI arrangements could undermine the rights of primary capacity holders. It is not the intention of Ofgem's proposal for UIOLI unduly to affect primary rights. However, it is the intention to ensure that unused capacity is offered back to the market. This could be done, in the first instance, by the primary capacity holder. However, if this was not seen to be occurring, it would be appropriate for the facility operator to offer that capacity back to the market.

7.7. In addition, the default regime could provide for flexibility to enable alternative market arrangements to be applied. These alternative arrangements would have to demonstrate that they are similar in effect in ensuring capacity is not hoarded. This issue is discussed in the context of the exemptions regime in chapter 8.

Information gathering powers

7.8. Importantly, in respect of anti-hoarding provisions and its other statutory duties, Ofgem would aim to acquire information gathering powers to ensure that market abuses in the use of infrastructure did not occur and that the requirements of the Directives and Regulation were maintained.

7.9. Ofgem would expect for example the disclosure of capacity utilisation, prices charged, information on real time flows. It might be appropriate to publish some of this data in order to facilitate transparency for market players. Any such

publication would need to take account of commercial confidentiality requirements.

Safety and contractual obligations

7.10. Any regulatory regime would need to specify the appropriate safety and contractual obligations such that facilities operate safely and correctly within the market, in a consistent way with other parts of gas and electricity networks and infrastructures.

LNG terminals and storage services

7.11. As set out in chapter 5, the new Gas Directive recognizes a potential for certain storage services to be separately offered at LNG import terminals.

7.12. The DTI and Ofgem consider it important that a consistent set of arrangements are applied in relation to the treatment of storage services across GB, including (as appropriate) any separately identifiable services at LNG import terminals.

Views invited

7.13. Views are invited regarding the default regulatory regime, and in particular the application of UIOLI and other anti-hoarding measures.

8. Requirements for granting an exemption

8.1. As set out in chapter 5, under the new gas Directive and electricity Regulation 'new' infrastructure projects will be free to apply to the relevant authority in each Member State for an exemption on a case-by-case basis from RTPA (or in the case of storage NTPA) requirements where the exemption criteria are met. This chapter sets out the steps and criteria that the DTI and Ofgem consider are important in arriving at a decision to grant an exemption. This includes a discussion of the reasons for differences between the default and exempt regimes. The final part of the chapter includes a table comparing the default and exempt regimes.

8.2. Our general view is that we would continue to treat an application for an exemption from the RTPA and NTPA requirements set out above in a similar way to how we have hitherto handled on-shore storage facilities under the Gas Act 1986. That is, when applying the exemption criteria, we would take into account the effects of the proposed market arrangements on competition and the impact of the facility in question on the economic and efficient operation of energy markets.

8.3. Further, the DTI and Ofgem believe that in applying the exemption criteria, our approach will have regard to issues such as ensuring competitive conditions **and** the particular nature of investments. "Lighter-touch" regulatory arrangements are only appropriate in effectively competitive markets or where certain infrastructure investments are demonstrably enhancing competitive forces. Markets where competitive pressures are relatively weak will require commensurately more direct regulation.

8.4. The Directives and Regulation set out the formal criteria that must be passed in order for an exemption to be granted. Paragraphs 5.14 and 5.15 set these out. The criteria are wide, and include competition issues. The following paragraphs set out Ofgem's initial views on how they might be applied.

Condition (a) : the investments must enhance competition in gas and electricity supply and enhance security of supply

Competition issues

8.5. Where markets are effectively competitive at all levels of the supply chain, new interconnector or LNG facility infrastructure can be expected to enhance competition in gas or electricity supply. The infrastructures should for example increase the possibilities for entry of new sources of gas or electricity and hence enhance competitive pricing. In these circumstances, Ofgem's initial view is that it will consider criterion (a) to be fulfilled if an assessment of competition shows that the market is effectively competitive at all levels of the supply chain both before and after the addition of the new infrastructure in question. This test will also satisfy the first part of criterion (e) below, since it requires no detriment of competition.

8.6. Alternatively, where the market at one or more levels of the supply chain is not effectively competitive, it will be necessary to assess in detail whether or not, and how, the new infrastructure contributes to an enhanced competitive position overall. In these circumstances, Ofgem will consider criterion (a) to be fulfilled where it can be demonstrated that the new infrastructure has a demonstrably positive impact on competition at one or more levels of the supply chain, and that this positive impact is not attenuated by the possibility of any reduction in competitive pressures elsewhere as a consequence of the new infrastructure.

8.7. The aim of these tests would be to demonstrate that the market in question is sufficiently competitive and remains competitive following the addition of the new infrastructure, or that the market is insufficiently competitive prior to the addition of the new infrastructure, but that the market will become more competitive after that infrastructure is built.

8.8. It is possible to gauge the extent and effectiveness of competition in any one market by looking at a number of discrete and appropriately defined quantitative and qualitative indicators, and the market conditions within which they occur. Appendix A discusses the particular indicators and necessary market conditions that we would expect to apply in the case of gas and electricity infrastructure. The appendix explains that a number of indicators should be used to establish

that the GB market is effectively competitive, or at least sufficiently competitive within the context of exemptions for certain infrastructure.

8.9. In addition, it will be helpful to consider the possible effects of proposed access arrangements for the new infrastructures on the competitive position. That is, it is important to ensure that access and use of infrastructure does not confer advantages to particular users that could result in market abuses. Three clear issues that arise here are :

a) Requirement to offer initial capacity to the market, i.e. 'open season' requirement

b) UIOLI arrangements

c) Appropriate information gathering powers

These points are considered in turn below.

a) Requirement to initially offer capacity to the market

8.10. Where there is a limited degree of third party access, for example where the infrastructure in question is developed mainly for the use of a single party, this places even greater emphasis on making an effective assessment of the impact of the use of that infrastructure in question on competition.

8.11. For particular projects that only aim, initially, to develop capacity for "own-use" purposes, clearly it would be easier to demonstrate that such infrastructure did not create competitive concerns where the developer in question is able to demonstrate that it had offered access to third parties, for example through an "open season" process. That is, an initial offer of capacity on an 'open season' basis would tend to preclude the possibility for a new infrastructure developer to size the facility in a way designed to exclude further development by others, and so would be consistent with a competitive market. In that case, subsequent 'own use' of the capacity may create fewer competition and regulatory concerns.

8.12. However, the DTI and Ofgem consider that the evidence of a sufficiently competitive market would by definition mean that third parties would have the potential to obtain access to other infrastructure or production sources. We nevertheless sympathise with the view that an open season undoubtedly

provides additional evidence to support an applicant's case that there are fewer regulatory concerns arising from exempting the facility in question.

8.13. As noted in appendix A, a particular exemption application would be subject to consultation. In this context, the consultation process could also importantly contribute to competition assessment. We would also necessarily have to consider any complaints made during the consultation or open season process by third parties regarding a lack of access to a particular interconnector or LNG facility.

8.14. Importantly, Ofgem and DTI consider that the above issues in relation to capacity rights are separate from the ongoing regulatory requirements of the facility. In particular, Ofgem and DTI consider that any unused capacity would be expected to be offered back to the market, through for example anti-hoarding mechanisms such as UIOLI, including for "own-use" facilities. This is discussed further below.

b) UIOLI arrangements

8.15. Access to facilities by third parties and hence competitive pressures are likely to be enhanced where capacity on an interconnector or LNG facility is offered on a UIOLI basis. Ofgem is therefore more likely to assess a market as being competitive following the introduction of a new infrastructure where such rules will be in place.

8.16. As discussed in chapter 7, the concept of UIOLI capacity would seem relatively straightforward to implement with respect to electricity and gas interconnectors. However, an effective UIOLI mechanism is potentially more difficult to design for LNG terminals. It would be the intention however that the existence of such an arrangement would be needed prior to a decision by Ofgem to allow an exemption.

8.17. As well as the detail of any UIOLI arrangements, we would want to consider the impact of the arrangements on primary capacity holders. It has been put to us that UIOLI arrangements could undermine the rights of primary capacity holders. It is not the intention of Ofgem's proposal for UIOLI unduly to affect primary rights. However, it is the intention to ensure that unused capacity is offered back

to the market. One way in which UIOLI can be made consistent with maintaining primary capacity holders' rights is as follows.

8.18. Infrastructure developers would be required to ensure that capacity is tradable. In addition, infrastructure developers would be required to ensure that nothing was done by them to hinder secondary trading. Then, the rights of primary capacity holders would be to use that capacity, or to trade it on. The infrastructure developer would be required to monitor the usage of its capacity. This would be via submissions to Ofgem. In the event that capacity was not being offered to the market by the primary capacity holder, Ofgem would have the ability to impose UIOLI rules, probably by placing a requirement on the infrastructure developer to introduce more stringent UIOLI rules. In any other circumstances, the primary capacity holder would retain rights to use, or trade the capacity.

8.19. This formulation is a step back from the imposition by Ofgem of formal UIOLI rules on infrastructure developers. However, as long as Ofgem reserves the ability to instruct infrastructure developers to impose UIOLI rules, this should given some comfort to primary capacity holders that "their" capacity will not be arbitrarily removed.

8.20. Of course, it is possible that there are alternative ways in which the regime could provide for flexibility to enable alternative market arrangements to be applied. These alternative arrangements would have to demonstrate that they are similar in effect in ensuring capacity is not hoarded. This issue is also discussed in the context of the exemptions regime in this chapter.

c) Information gathering powers

8.21. Access to facilities and hence competitive pressures will also be enhanced where certain data regarding the facility is published and so available to third party users. We have been asked for guidance as to what information we might want to see published. We do not have a final view as this stage, but such information could include:

- Expected capacity utilisation
- Actual capacity utilisation

- Prices charged for third party access
- Real time information flows

Security of supply issues

8.22. In relation to security of supply, the DTI and Ofgem would generally consider that efficient investment in interconnectors and LNG can significantly increase the diversity of import supply sources. Clearly, consumer interests are best served by focusing regulatory effort upon designing the market to deliver sufficient price signals to enable parties to respond to investment and security of supply needs in an efficient manner. In this respect, facilitating infrastructure investments by developers other than incumbent TSOs better allows a diversity of information and views regarding future demand and supply scenarios to be better expressed and acted upon. Therefore, as a general principle Ofgem and DTI see benefits in encouraging competitive development of infrastructure on a merchant basis, subject to the safeguards provided by having an effectively competitive market and regulatory measures to avoid market abuses.

8.23. In addition to the benefits of market-based investment signals, the regulatory regime should aim to ensure that, once constructed, the operation and use of interconnectors and LNG facilities interacts appropriately with existing arrangements, for example the balancing regime, that ensures short-term security of supply. Therefore, part of the exemptions consideration would be to ensure that the operators and users of that infrastructure were aware of the necessary contractual obligations and interactions of that infrastructure with relevant networks.

Condition (b) : the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted

8.24. The construction and operation of new infrastructures will only be economically justified where returns are sufficient to meet the risks of the project. The default regulatory regime in GB for network infrastructures has generally been set on the

basis that investment in onshore network assets is a relatively risk-free activity, and therefore regulated returns have been limited to around 6.25 per cent[5].

8.25. It is likely that new interconnector and LNG infrastructure projects will be subject to considerably more uncertainty and risk than onshore network assets. It is in this light that project developers sometimes assert that were the default onshore network regime and returns to be applied to such projects, it is unlikely that they would be economically justified or indeed obtain project financing. On this basis it is further asserted by project developers that such projects would not be built without the benefit of an exemption.

8.26. In addition, explained above, the main difference between the exempted and default regime would be the ex-ante approval of tariffs and the control of revenues. On this basis an important feature of this criterion is whether the nature of the infrastructure in question is such that it is not appropriate for it to be remunerated through the default regulatory regime. This appears to be particularly important in relation to the requirements for the regulation of revenues from interconnectors under the electricity Regulation.

8.27. The GB regime sets out a number of criteria to ensure that onshore gas and electricity networks are developed in way that best protects consumer interests. A certain amount of a TSO's activity is therefore based around predicting reasonably foreseen demands and setting out a "baseline" investment plan to ensure that the network can accommodate expected flows. The GB regime also aims at ensuring that TSOs have sufficient incentives to respond to investment over and above baseline levels. However, in general terms the TSO can obtain a guaranteed regulatory return against any baseline investment through network tariffs. This enables the TSOs to recover any (efficiently incurred) baseline investments costs from the generality of network users for network reinforcements that were not subsequently required, for example due to changing demand patterns. This regime applies both to Transco's and NGC's transmission network investments.

[5] Real pre-tax Weighted Average Cost of Capital

8.28. There appear to be clear differences between the appropriate treatment of interconnector investments that might be expected in GB and the type of network investment activity explained above in relation to extensions or reinforcements of the transmission network. It is also worth highlighting on this latter point that most "interconnection" in continental Europe simply requires an over-land extension of the transmission network to a border, which less clearly justifies a differential treatment to other forms of network investments. For large and expensive infrastructure projects such as sub-sea DC-interconnectors, there more clearly appears to be a need to protect consumers from bearing the possible risks, in particular if the infrastructure project in question were unable to recover its sunk investment costs from the users of the infrastructure.

8.29. Therefore, the development of risky investments such as interconnectors and LNG infrastructure would not fit within the class of infrastructure developments that would ordinarily be allowed to recover costs as part of the Transco or NGC network activity remuneration. In this framework, however, if there are not any possibilities for investors to obtain protection from possible downside risks of the investment (through recovery of costs on all network users), Ofgem accepts that the project developers should also therefore be able to recover any upside returns of the project.

8.30. The previous discussion has highlighted the priority the DTI and Ofgem attach to the need for competitive market conditions. An important point is that where it can be demonstrated that the market is sufficiently competitive, competing infrastructures or supply sources will limit the opportunity for excess returns from that infrastructure. On the other hand, where there is insufficient competition, this could imply that a particular infrastructure project could enjoy a dominant position in the market in question. For the GB market, the DTI and Ofgem would be unlikely to consider exemption to be appropriate where for example, the infrastructure owner were able to enjoy a dominant position since this would be inconsistent with competition. But the essential point is that competition can provide necessary protection to ensure that exempted infrastructure cannot recover excess returns.

8.31. In sum, new infrastructures are unlikely to be built if returns are limited to that provided for onshore networks, because risks for these projects are probably greater than for onshore networks. It would be inappropriate for onshore

network customers to bear these greater risks since they will derive little direct benefit from the infrastructure developments. In a competitive market, project financiers will bear the risk and upside returns will be capped by competitive pressures. It is appropriate to conclude therefore that in certain circumstances major new infrastructures may well not be built unless an exemption is granted.

Condition (c) : the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built

8.32. Ofgem would expect project developers, where they are owned by or linked to system operators, to demonstrate that entities for the infrastructure ownership or development are at least legally separate from the system operator or operators. Ofgem also takes the view that in general it facilitates transparency and minimizes opportunities for cross subsidy and discriminatory behaviour where transport facilities such as interconnectors and LNG facilities are at least legally separate from other upstream and downstream activities. Ofgem would also expect that such separation would extend to ensuring that transmission or distribution system revenue would not cross subsidize interconnector projects, hence addressing the condition applying to electricity interconnectors described in paragraph 5.15.

Condition (d) : charges are levied on users of that infrastructure

8.33. Ofgem will require infrastructure developers to demonstrate that this criterion is satisfied.

Condition (e) : the exemption is not to the detriment of competition or the effective functioning of the internal gas or electricity market, or the efficient functioning of the regulated system to which the infrastructure is connected or linked

8.34. The first part of this test regarding the detriment of competition will be included within the assessment of criterion (a), as discussed above.

8.35. To some degree, this condition clearly appears also to relate more closely to interconnectors and is largely aimed at ensuring that due account is taken of the potential impact of exempting infrastructure from regulation on other Member States. For electricity, interconnections from GB to other Member States will be on the basis of DC technology and many of the technical issues surrounding AC interconnectors, such "loop-flows" will not arise. Nevertheless, in assessing whether or not this criterion is met, Ofgem will seek to ensure the interconnector operator and users were bound by technical, safety and contractual rules and responsibilities necessary in interconnecting different systems. In addition, particular market circumstances, for example interactions of different balancing regimes and markets between Member States would need to be established. In this respect Ofgem would seek dialogue with the relevant authority of the regulated system to which the infrastructure is connected.

The default and exempt regulatory regime

8.36. Table 1 below sets out the main differences between the default regulatory and the regime that might be expected to apply for exempt infrastructure.

Table 1: Differences between default and exempt regulatory regimes

	Default regime	**Exempt regime**
Regulation of tariffs and revenues	Infrastructure operators will be required to offer terms on a non-discriminatory basis	Not applicable
	Infrastructure operators will be required to publish tariffs applicable to customers	Not applicable
	Regulatory authorities shall ensure prior approval of the tariffs or methodologies	Not applicable
	For electricity interconnectors, the use of revenue from the allocation of interconnection must be prescribed as set out in the electricity Regulation	Not applicable

Management and allocation of capacity	Infrastructure operator will make an initial offer of capacity to market	Applicable (although under specific circumstances this condition might be loosened)
	Interconnector operator will always make unused capacity available to market on an ongoing basis through a 'Use it or lose it' or other anti hoarding type provisions. Any such provisions should allow for flexibility in order to accommodate differing market arrangements	Applicable
	Interconnector operator will be required not to impede secondary trading of purchased interconnector capacity	Applicable
Information gathering powers	Infrastructure owner or operator will be required to provide information to Authority such that the Authority can monitor and enforce regulatory regime	Applicable
	Interconnector owner or operator will provide relevant information to market enabling market participants to evaluate availability and worth to themselves of interconnector capacity	Not applicable (although under specific circumstances it may be appropriate to retain some obligations)
Other	The possibility for flexibilities so as to accommodate arrangements and interactions with Member States with which the interconnection exists	Applicable
	The various technical and contractual conditions	Applicable

8.37. As discussed in chapter 5, the proposed EU legislation only provides for an exemption from RTPA. In particular, the DTI and Ofgem would expect that both EU and domestic competition law would continue to apply.

Duration and withdrawal of an exemption

8.38. The DTI and Ofgem consider that there are a number of options with respect to the duration of the exemption. It will be necessary to strike a balance between granting long and/or guaranteed durations that have the benefit of giving certainty to investors, and granting shorter and/or contingent durations that have the benefit of allowing for changes in the competitive environment.

8.39. One appropriate way of striking the balance would be to grant long duration exemptions where Ofgem is reasonably satisfied that criteria for the grant of an exemption will continue to be met (for example relevant markets are and will remain effectively competitive), and/or where appropriate re-openers to the exemption exist. In order to retain relative certainty for investors, these re-openers should be clearly set out and structured in order that all parties understand the circumstances and likelihood of the exercise of them.

8.40. The re-openers would amount to an event or circumstance that would entitle Ofgem to revoke the exemption. Ofgem anticipates that this would encompass circumstances where a party ceased to meet the criteria for grant of an exemption under the EU legislation. Potential re-openers also include any investigations under EU or UK competition law into the behaviour of the party holding the exemption that reveal anti-competitive behaviour. Merger or acquisition activity involving the party holding the exemption could also be a re-opener, where the merger activity leads to a potentially less competitive market at any stage of the supply chain.

8.41. An important element to the potential access by third parties to any new infrastructure, and hence the possibility for ongoing enhancements to competition, would be any open season tender for capacity by a project developer in the initial stage of development. Such an open season would tend to preclude any possibility for a new infrastructure developer to size the facility in a way designed to exclude further developments by others. Hence, all other things being equal, a longer duration or time unlimited exemption will tend to be justified where it can be demonstrated that the facility has been through an appropriate open season process.

8.42. Where it is not possible reasonably to foresee the likelihood of effective markets continuing to operate in the longer term, or where access arrangements associated with the project in question are relatively closed, an alternative approach may be to grant relatively short duration exemptions, of say five years, with the guarantee that such exemptions will remain in place for that period. The exemption will be reviewed after this period, taking into account the criteria for the grant of the exemption, with a view either to extending or revoking the exemption.

8.43. In addition to the above, it will be important to note that EU and UK competition law will continue to apply to project arrangements regardless of any exemption granted from the default regime. Where there will be regulatory oversight of infrastructure arrangements through the application and potential enforcement of competition law, all other things being equal, a longer duration exemption from RTPA may be justifiable.

8.44. Ofgem also notes that it is the policy of the Commission DG Competition to limit relevant clearance for agreements, which meet certain conditions, from certain provisions of EU competition law, to periods of up to 15 years. Using this as a guide and in the absence of other effects, Ofgem considers that a 15 year exemption period is an appropriate general starting point for considering the duration of an exemption from RTPA requirements. Certain market features and arrangements, as discussed above, might justify a longer exemption than the 15 years. Alternatively, certain market features and arrangements might justify a shorter exemption than 15 years, or a formal review of the exemption after, say, five years.

Views invited

8.45. Views are invited regarding any issues raised in this chapter, particularly regarding :

- the assessment of the criteria and the competition issues
- the duration of any exemption
- the exempt regulatory regimes

9. Conclusions

9.1. This document sets out the DTI and Ofgem's initial views of the likely approach to be taken regarding the default regulatory regime and exemptions regime for interconnectors and LNG facilities under the new Directives and electricity Regulation and seeks the views of interested parties.

9.2. Our initial view, as set out in this paper, is that default obligations will comprise among other things the publication of tariffs on a non-discriminatory basis, with the tariffs or tariff methodologies approved ex ante by the regulatory authority. There will also be certain rules relating to the offer to the market of capacity rights to access these infrastructures. This document sets out our initial view as to how the exempt regime will differ from the default regime. However, it notes that even if an exemption were granted, we would continue to set out certain *ex-ante* rules, in particular to prevent capacity hoarding.

9.3. The relevant authority, likely to be Ofgem, is expected to have powers to grant an exemption to a major new infrastructure project. In order to be eligible for any exemption, the project must satisfy all criteria of the EU Directives and Regulation. This paper discusses our initial views on how these criteria may be applied. The paper also discussed that the precise form of any exemption, for example, its duration might vary depending on the nature of the project in question. In any case, Ofgem expects to consult on a case-by-case basis on any exemption applications requested by infrastructure developers.

9.4. It is important to note that the new EU legislation has not yet been implemented into UK law and that any amendments to UK law which are made in order to do so may be different to those currently envisaged. The initial views set out in this paper may change if the requisite amendments to UK law prove to be different to those envisaged, or as a result of any responses to the initial views set out in this paper. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into UK law and initial views of how the new regulatory regime may operate.

Appendix 1 COMPETITION INDICATORS

1.1 An appropriate competition analysis will include (but not be restricted to) an assessment of likely market share, including an appropriate definition of the "relevant market". Quantitative analytical tools such as market share analyses, Herfindahl indices and concentration ratios could provide useful "indicators" regarding the appropriateness of granting an exemption. Clearly the limitations of such indicators would need to be appreciated. In particular, such indicators would need to be supported by additional quantitative and qualitative analyses that capture all potential market interactions arising from access and use of the infrastructure, including the impact of that infrastructure in locational and temporal markets etc.

Quantitative indicators

1.2 The most important factor to consider appears to be in terms of the competition between the user of capacity rights for that particular infrastructure (which could potentially be 100% of capacity and for an unlimited time period) against relevant alternative sources of gas or electricity supply.

1.3 For gas markets, the key comparisons may include:

- the level of upstream competition
- contractual position at the beach
- the level of downstream competition

1.4 For electricity markets the comparisons may include:

- Who owns the power stations/capacity rights on other interconnectors (production)
- Who supplies the power (supply)

1.5 We would expect to carry out the analysis of the market both pre and post the new source of gas / power connecting, to check that a) the market is competitive and b) it stays competitive in light of the new infrastructure.

Qualitative analysis

1.6 In providing a competition assessment, in addition to the factors above, there are a number of other qualitative factors that that would appear to provide clearer evidence that an exemption would be appropriate, these include:

- Effective separation provisions that ensure non-discriminatory access conditions;
- Regulated third party access conditions for network services;
- Freedom of entry and effective competition in supply, generation and shipping activities (this could draw, for example, on analysis in the Commission's benchmarking surveys);
- Liquid trading hubs/markets (this could be supported by quantitative measures); and
- An established independent regulator with a duty to promote competition.

1.7 Again, without a number of these conditions within the market, it makes it difficult to establish that an exemptions regime would be appropriate. A lack of effective network access by definition would limit the degree of competition that might be expected between interconnectors and other sources of supply; liquid traded markets also limit the ability of players to manipulate markets; the establishment of an independent regulatory authority with a duty to promote competition would provide better certainty that these market conditions would continue to prevail and would also support the case that competition factors were independently and appropriately considered.

1.8 In addition, it should be noted that a particular exemption application would be subject to consultation. This could potentially highlight additional competition concerns not already captured. The DTI and Ofgem believe that due to the size and potential importance of these projects, it is important that an effective consultation process can be demonstrated as part of the competition assessment. In particular, we would have to take seriously any complaints or concerns by third parties regarding a lack of access to a particular interconnector or LNG facility.